

Office of Chief Counsel
Internal Revenue Service
memorandum

CC: [REDACTED]:TL-N-7345-99
[REDACTED]

Date: December 16, 1999

To: District Director, [REDACTED]
Attn: [REDACTED] Group Manager [REDACTED]

From: District Counsel, [REDACTED]

Subject: Request for Advisory Opinion
Taxpayer: [REDACTED]

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This refers to your request for our assessment of the litigating hazards with respect to two issues in the above-entitled case.

ISSUES

1. Whether the taxpayer is entitled to deduct payments made to each of the States in settlement of lawsuits initiated by the States of [REDACTED] and [REDACTED] for alleged price-fixing in violation of federal and state anti-trust laws.

2. Whether the taxpayer is entitled to deduct the cost of construction of excess capacity in a [REDACTED] [REDACTED] that was gifted to the [REDACTED] along with the taxpayer's right to reimbursement by "newcomers" to the city's [REDACTED] [REDACTED] system.

FACTS AND DISCUSSION

Issue 1.

On [REDACTED], the States of [REDACTED] and [REDACTED], through their Attorneys General, and as *parens patriae* on behalf of all residents of their States who had purchased [REDACTED] [REDACTED] during the alleged price-fixing period, filed a lawsuit in the [REDACTED] against the taxpayer seeking injunctive relief, civil penalties, and monetary damages. The States sought treble damages; a \$ [REDACTED] penalty for each alleged violation; costs of the litigation; and an injunction. The Attorneys general also filed a "Settlement Agreement" that was entered into prior to the filing of the complaint. On [REDACTED], the [REDACTED] of the [REDACTED] and the Corporation Counsel for the [REDACTED] filed substantially similar complaints and settlement agreements.

Pursuant to the agreement with [REDACTED] and [REDACTED] (and we assume with the [REDACTED]), the taxpayer agreed, among other things, to cease and desist from any price-fixing activity. It agreed to pay a total of \$ [REDACTED] of administrative costs, and to issue \$ [REDACTED] (instant redemption certificates) to Qualified Purchasers for up to \$ [REDACTED]. Finally, it agreed to pay the "Plaintiff [REDACTED]" the sum of \$ [REDACTED] (and up to \$ [REDACTED] more depending upon the redemption of the coupons). The "Plaintiff [REDACTED]" were defined as "the [REDACTED] and [REDACTED], and [REDACTED] and the [REDACTED] which opt

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

to enter into the terms of this Agreement" The Settlement Agreement states that:

" [REDACTED] ."

The \$ [REDACTED] payment (plus the additional amounts up to \$ [REDACTED]) was to be divided among the Plaintiff States by each State's percentage of the national population. The payments were to be used by the Plaintiff States for one or more of five specified purposes, including "a cy pres use to benefit those unidentified consumers for whose benefit the settlement was entered into, i.e. purchasers and users of [REDACTED] Products" This is consistent with the parens patriae concept, which recognizes that a state has a quasi-sovereign interest in the economic health and well-being of its residents in general as opposed to that of specific residents. Alfred L. Snapp & Son v. Puerto Rico, 458 U.S. 592 (1982).

The settlement agreements were approved by an order of the district court dated [REDACTED]. In its order the court states that "[REDACTED]"

The issue is whether these payments are deductible under I.R.C.

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

§ 162(a) or are nondeductible under § 162(f) as a "fine or similar penalty." Treas. Reg. § 1.162-21(b)(1)(ii) and (iii) provide that "a fine or similar penalty" includes amounts that are:

- "(ii) Paid as a civil penalty imposed by Federal . . . law . . . [or]
- (iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal)"

Section 1.162-21(b)(2) provides that "[c]ompensatory damages . . . paid to a government do not constitute a fine or penalty."

In Talley Industries Inc. v. Commissioner, 116 F.3d 382 (9th Cir. 1997), the court considered the deductibility of payments in a situation substantially similar to the instant case. In describing the test for determining whether an amount is a "fine or similar penalty" under § 162(f), the court quoted from Southern Pac. Trans. Co. v. Commissioner, 75 T.C. 497(1980), as follows:

"If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, [the payment is not deductible]. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it [is deductible because it] does not serve the same purpose as a criminal fine and is not 'similar' to a fine within the meaning of section 162(f)."

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Citing Waldman v. Commissioner, 88 T.C. 1384 (1987), aff'd 850 F.2d 611 (9th Cir. 1988), the court went on to point out that:

"[i]f the 'payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible),' the tax court must 'determine which purpose the payment was designed to serve.'"

Concluding that the evidence did not establish the purpose of the payments, the Ninth Circuit in Talley remanded the case to the Tax Court for a determination of the nature and purpose of the payment in question. On remand, Talley Industries, Inc. and Consolidated Subsidiaries v. Commissioner, T.C. Memo. 1999-200, 77 T.C.M. 2191 (1999), the Tax Court held that the settlement payment was not deductible because the taxpayer failed to show that the payment represented compensation for losses caused by the taxpayer, rather than a penalty. The court emphasized the fact that the settlement agreement in that case did not characterize the payment as either compensation or as a penalty, indicating that the petitioner would have been able to establish its entitlement to a deduction if the settlement agreement had characterized the payment as compensation.

In the instant case, the settlement agreements characterized "all payments described in this Agreement solely as compensatory damages." We consider this factor to be a substantial hazard for the Service in the event of litigation on this issue. Furthermore, there is no evidence in the file to refute this characterization of the payments. In these circumstances, we do not recommend that the issue be pursued by the Service.

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Issue 2.

The taxpayer built a new [REDACTED] center ([REDACTED] in [REDACTED], in [REDACTED]. To satisfy the taxpayer's needs arising from the new [REDACTED], the taxpayer and the city entered into discussions regarding the construction of a [REDACTED] [REDACTED]. As a result of the discussions, the city requested the taxpayer to construct a [REDACTED] [REDACTED] with excess capacity beyond that needed by the taxpayer, and the taxpayer agreed. In order to reimburse the taxpayer for the additional costs of the excess capacity, the city and the taxpayer agreed that the taxpayer would receive fees generated by subsequent users of the [REDACTED] [REDACTED], limited to the construction costs allocable to the excess capacity.

The understanding between the taxpayer and the city was set forth in an agreement entered into on [REDACTED]. Under the agreement, the taxpayer was liable for [REDACTED] percent of the cost of the [REDACTED] [REDACTED], representing the percent of the capacity that the taxpayer needed. The excess capacity would benefit either current or future users within the city. The taxpayer agreed to deed the [REDACTED] [REDACTED] to the city upon completion.

The [REDACTED] [REDACTED] was completed and, on [REDACTED], the taxpayer conveyed it to the city. Because of the difficulty of administering the reimbursement rights (payments from subsequent users), on [REDACTED], the agreement was modified to cancel the right of reimbursement.

The taxpayer claimed a deduction in [REDACTED] of the entire cost

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

attributable to the excess capacity of the [REDACTED]. The Service has challenged the taxpayer's entitlement to a deduction apparently on two grounds. First, the Service contends that the taxpayer cannot deduct the cost of the excess capacity because the taxpayer was obligated by contract to convey the [REDACTED] prior to its conveyance. Secondly, the Service contends that the taxpayer cannot claim a deduction for the cancellation of the right to reimbursement because it had no value, based upon the Engineering Memorandum Report (EMR) dated [REDACTED], which concludes that the right of reimbursement "[REDACTED]."

We do not believe that the Service's first contention could be sustained in litigation. The agreement between the taxpayer and the city contemplated the construction of the [REDACTED] by the taxpayer and the conveyance to the city upon its completion. The agreement and the conveyance were all part of the same transaction, and they cannot be separated to deny the taxpayer the deduction. See Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968).

Likewise, we do not consider the Service's second contention to be sustainable in the event of trial. The taxpayer agrees that "[i]t would be difficult, if not impossible, to decide the fair market value of the Right under the agreement . . . ," because of the uncertainty of future revenue from development within the city. (Attachment 3 to EMR). However, as the taxpayer points out in the same attachment, the courts have resolved this difficulty by assuming that, in an arm's length transaction, the two properties that change hands are equal in value. United States v. Davis, 370 U.S. 65 (1962). The court in Davis was considering a situation in which,

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

pursuant to a property settlement, the taxpayer-husband conveyed appreciated stock to his wife in return for her relinquishing any further marital rights against him. The court calculated the taxpayer's gain on the transaction by assuming that the marital rights had the same value as the stock. In this case the right to reimbursement was received by the taxpayer in an arm's length exchange for the excess capacity of the [REDACTED], which had a readily ascertainable value. Under the reasoning of Davis, supra, the value of the right to reimbursement would equal the value of the excess capacity.

Furthermore, if the Service takes the position that the right to reimbursement had no value when it was canceled, it is reasonable to believe that it likewise had no value when the taxpayer received it. Therefore, the taxpayer received nothing of value pursuant to the agreement with the city that could be used to reduce the value of the excess capacity conveyed to the city and a deduction for the value of such excess capacity should be allowed.

We are closing our file. If you have any questions regarding this matter, please contact the undersigned/at ([REDACTED]

[REDACTED]
Special Litigation Assistant

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Collection, Criminal Investigations, Examination or Appeals, recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Criminal Investigations, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.